WallStreetWindow Monthly

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The Little Known Fed Bubble Now Slowly Killing the Stock Market– Mike Swanson

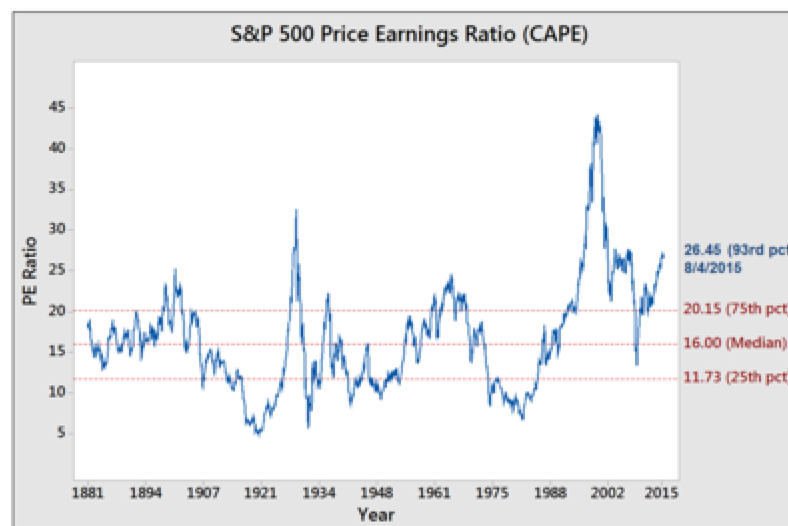
I know most people who open this up are going to just hit the button and not read it, because they do not want to hear that something is wrong with the stock market. And many just cannot believe it, because over the past few weeks the stock market has bounced hard much like it did last October. But the stock market is slowly dying and this is just a bear market rally that puts the small fry asleep on the risks he is taking in the market just like the bounce in October did. Something is wrong with the stock market and they do not even know it and don't want to be told about it. But a few will read and it is you and them I focus on. And if you read it you will be able to tell when the current bounce will end.

The goal of this monthly newsletter is to understand what is happening so that we can make wise decisions with our resources and make our own good contribution to the world. And this takes knowledge. It takes understanding the past and scrutinizing the present. And todaoy we are going to do that when it comes to the US stock market so that we can understand why it is now dying.

The stock market has been falling since July and in the news there are all sorts of bad stories out there people are using to explain the declines. The US news media talks about problems in China and the big drop in oil prices that is ruining the revenue streams of American oil companies and the balance sheets of institutions that hold their debt instruments. Suddenly in the past few weeks the share prices of European banks have also taken a scary slide and we have seen a failed intervention by the Bank of Japan to make its stock market go up again. The US stock market is down this year, but the news media does not say that there is something wrong with it. It seems to want to blame the decline on events in other countries. In reality it is sick. And we must diagnose it's sickness as a doctor would with a patient to see if it can get better or if this is just a temporary fever it is suffering from.

The picture you see on the front page of this newsletter is one of the US stock exchange in New York City. I stood right on the corner in that picture you see above about seven year ago and bought a hot dog. I haven't been back there ever since. What I want you to notice though is that this big building is draped with the American flag. This isn't just because the people that own the US stock exchange are super patriotic, but because the share prices of the stocks that trade on the US stock exchanges themselves have been tied to government action and dependent on successful government action to make them go up. Stock prices are supposed to move up and down in a way as close to a free market as possible, but that has not been what has been happening since the Wall Street crash of 2008. But in January something started to go wrong.

And so now the United States stock market is suffering from policy errors that have put it in a terrible condition. There were all sorts of technical warning signs a year ago that the stock market was going to go into a bear market. By technical I mean that there were patterns to the way the market was trading that were playing out that have always preceded bear markets in the past.



Source Data: Robert Shiller (Cyclically Adjusted PE Ratio or CAPE).

For one thing stock valuations simply reached a manic level. The chart above is the cyclically adjusted P/E ratio for the S&P 500. It takes the annualized P/E of the S&P 500 for ten years and adjusts it for inflation. This ratio had only reached the crazy level it did last year three prior times in its history. Those years were 1929, 1999 and 2007. Vicious bear markets ate investors alive in the years that followed.

More importantly though the number of stocks going up became fewer and fewer in number as the months went by starting at the end of the 2014. What happened is that most stocks went into a bear market in 2015 while the market averages were being held up by just a few stocks. In July at the final top there were about two dozen leaders in the Nasdaq 100 doing most of the heavy lifting in the market and by the end of the year the only stocks really going up anymore were just the so called "FANG" stocks as CNBC called them. These were Facebook, Amazon, Netflix, and Google. Bull markets typically end when only a few stocks remain that are going up while most of everything else languishes. And so a bear market began in January when the market dumped.

I saw these signs last year and warned people about them over and over again. But I did not know the fundamental "cause" or "reason" for the coming bear market last summer. I just knew that the trading patterns were bad, the valuations were sky high, and trouble was going to come. But by December I came to understand that there was a real fundamental problem brewing that was going to make the stock market sick again like it was in 2008.

In that last bear market I got bearish in the fall of 2007. In November and December of 2007 I was telling people that we were in a bear market, much as I am saying now. And I was bearish for the same reasons I got bearish this fall. On both these occasions I was looking at the poor technical action in the market and the horrible leadership and market breath that have always preceded a bear market when they happen. I also got hold of an internal Federal Reserve report in 2007 that said that real estate prices were going down the tube and the Fed was prepared to cut rates rapidly to zero. It didn't take a genius to know that meant a serious recession and stock market drop was coming too.

But I didn't know how badly the banks were in trouble until February of 2008. There was a wild stock market gyration in January of that year that made me even more concerned and thinking that a crash could eventually come. I wanted to know why things were so bad so I read lots of articles and talked to lots of people and found out that 10% of the assets on the balance sheets of banks were worth zero when they had them marked up as if they were still worth something. And we all know what happened next.

This past December I spent a lot of time once again talking to people and doing real research looking at individual stocks. Most stock market bulls that you see on TV just invest on slogans and buy and believe. Few people on Wall Street do any work or real analysis at all. They just cheerlead bull markets. If you watched The Big Short that is something you should take from that movie.

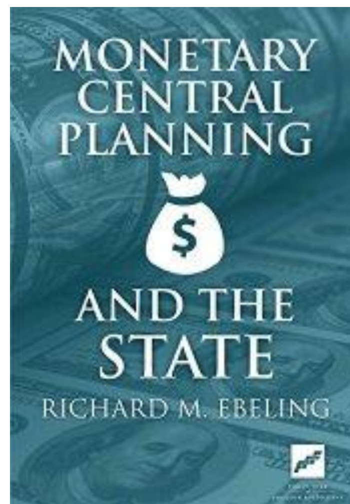
I came to see before Christmas that there was something seriously wrong with the stock market and it was about to get sick. I did videos and a lengthy PDF report for my premium and private Power Investor group laying out why the stock market was in real fundamental trouble. I kept this information tight, because I did not want to just send it all out into the public and be accused of yelling fire in a building. And frankly they always get the details first.

But now that the fire has started I want to explain to you why it is so dangerous. This information helped Power Investor members realize the magnitude of the problems and helped them ignore all of the calls by bubble bulls for giant gains in 2016. So many of them were able to get ahead of the curve and prepare ahead of the big declines. But if you read this information now it can help you take action by understanding what is happening too. Much of what you are about to read is adapted from something I wrote for Power Investor members back in December.

What you need to know now in order to understand why the stock market is dying is to understand why it went up. Everyone knows that the Federal Reserve did something to make the stock market go up in this past bull market.

People believed that the Fed had things under control and that they printed money to make the market go up. But what they don't know is how that really worked.

There is a school of economic thought called Austrian economics. I first heard of it during the 2000 bear market when I read about it on financial websites and saw Congressmen Ron Paul talk about it. He sat on the House Banking Committee and had these fascinating exchanges with Alan Greenspan about economic policy. If you want to really study up on Austrian economics then grab this book by Citadel economics professor Richard Ebeling. Click the book to go to Amazon to buy it:

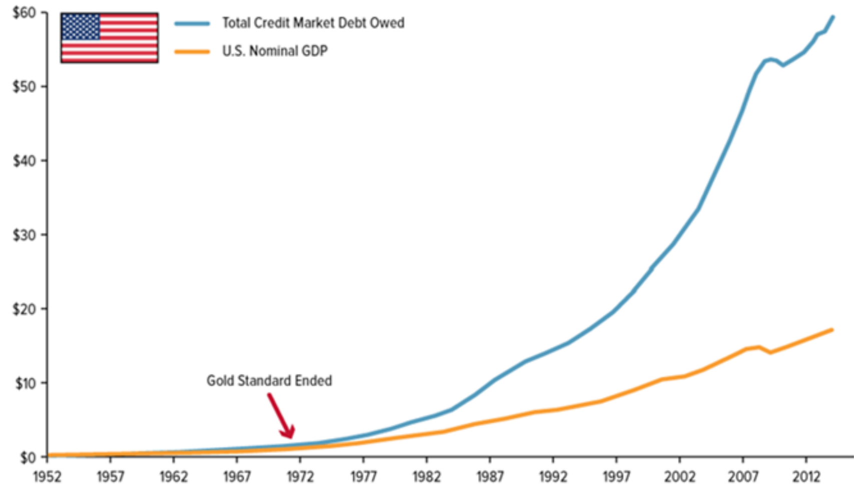


For a quick thumbnail sketch from me - Austrian economics was created during the 1920's and 1930's and used as an explanation for the Great Depression. It argued that the Federal Reserve creates financial bubbles by manipulating interest rates and the money supply, which causes investors and business people to make investing mistakes that they would not do otherwise. For example a lot of people should be in safe investments right now paying them good dividends, but instead they feel forced to gamble in the stock market, because banks pay them nothing thanks to Fed action.

Now in the 1920's the Federal Reserve believed that it needed to keep the prices for various goods at a high price for the economy and that the dollar needed to trade at a low value to the British pound. That caused business people to invest in factories in order to sell more goods at these nice high prices. It caused others to invest in a real estate bubble centered in Florida and for stock market gamblers to believe that the stock market was priced cheap when it wasn't.

In other words the Federal Reserve created an artificial boom that eventually went bust in 1929. We saw the same thing happen in the 1990's with internet stocks and then a decade later with real estate prices when the Federal Reserve kept interest rates too low for too long. It created bubbles that simply caused more problems when they went bust. And then they responded the same way again. The Fed made another bubble bust that is now slowly killing the stock market.

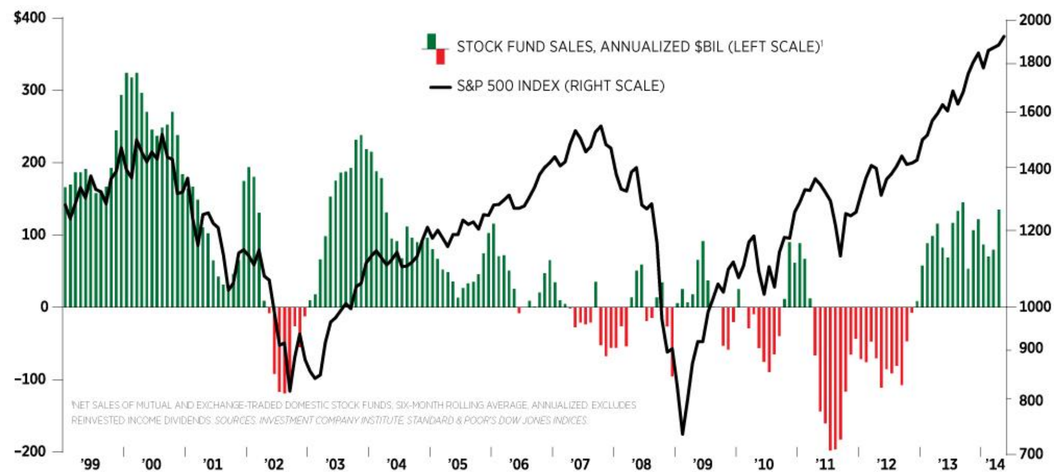
Take a look at this chart.



Everyone knows that the US government debt is growing and that it cannot grow forever. Debt growth has broken away from GDP growth. So there is a fear that one day that could cause a big economic collapse. In fact the Congressional budget office projects that if the deficit is not put under control that this will turn into disaster in thirteen years. So everyone that worries about bubbles and debt worries about this. But the Federal Reserve has actually created a debt bubble in the corporate bond market that is already beginning to pop.

That is why the stock market is slowly dying. Stock market bubble bulls believe that the Fed can just step in and make a new giant money program to make the stock market bull market come back if they have to, but this is no longer the case. You see people do not really understand why it is that the stock market went up like it did from 2012-2014. I get emails from some bubble bulls who claim that the Fed is actually buying stocks or manipulating the stock market. They have no evidence for this though and it really isn't true. They are right that the Fed has influenced the stock market with zero rates and quantitative easing, but they really do not know how these things really work. And they assume that the Fed will just make the market go up for them no matter what it might mean for the rest of the economy.

They just grasp on to any reason to believe it will go up and curse at people who try to caution them. Two things have happened in the past few years. The first is a big drop in real liquidity in the stock market. The individual investor actually took more money out than he put into the market from 2009 until 2012.



Then in 2013 he did start to put more money into the market again as he chased the market up. That did help make the stock market go up, but the actual amount of money that the masses have put into the market actually pales in comparison to what they put into the market during the last two bull markets. Now margin debt boomed there is no doubt about that as people have used the low rates to borrow money and the gamblers have doubled down as stocks went up. But the actual amount of new money people have put into the market is not that large. The real reason why is that people are simply poorer now than they were before the 2008 financial crisis. The economy has not produced wealth for the regular person and many after 20008 found themselves retired, jobless, and with fewer resources.

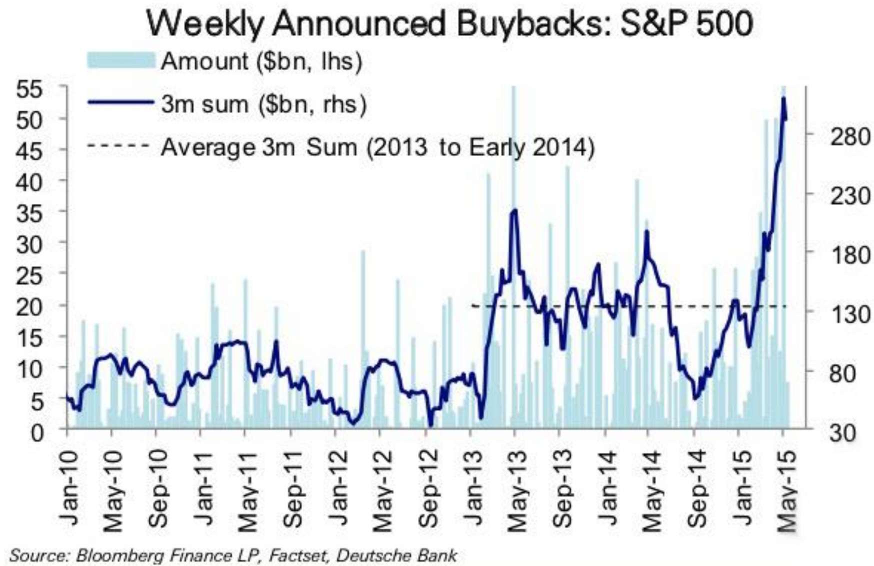
So then where did the buying to fuel the stock market so high come from? Most of the actual trading in the stock market is not coming from individual investors or even real people, but from computer programs. These programs do not invest or hold overnight. They just jump in and out of stocks. When the programs disappear though stocks can dump in seconds.

We saw that happen this past August when the DOW gapped down over 1,000 points one morning and during the "flash crash" of a few years ago. These robot buyers are vanishing in many stocks right now, especially low volume stocks. It's a topic of the Michael Lewis Flash Boys book.

One thing these programs do is look to buy stocks that are stronger than the stock market and not really correlated with it. They need stocks with high volume to be able to trade them so they flock into big cap momentum stocks. They do not really operate in stocks with low volume or in decline. So as the internals of the stock market have disintegrated and more and more stocks have gone into bear markets this year these programs have focused on trading in fewer and fewer stocks. When you see a big cap gap up and go up all day that is computer buying. Such moves in a few stocks have helped create rallies in the market whether they last a few hours or a few weeks like the one this past October did and the one that started in February. But in times of stock market trouble the programs essentially turn themselves off. That means we could see big sudden stock market decline someday soon.

More important than these short term trading programs though are corporate stock buyback programs. Now these programs BUY stocks and take them off of the stock market. Buybacks do not buy

and then sell a stock. They remove shares from the stock market and limit stock supply. So they do drive stock prices higher. The biggest companies in America are doing buybacks.

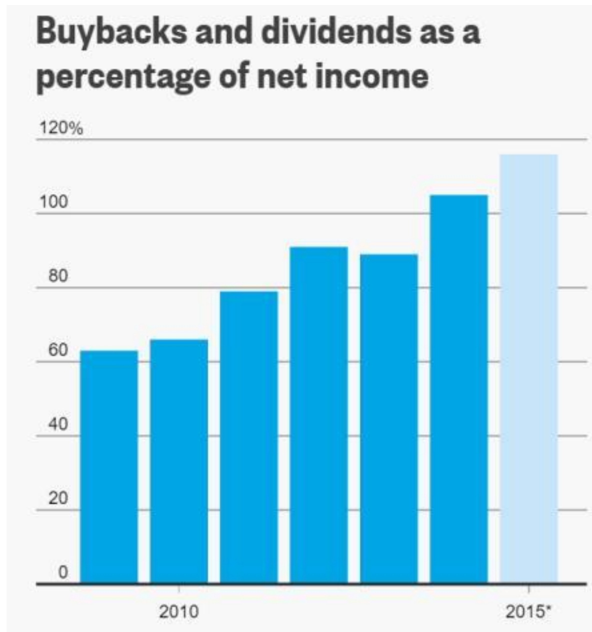


Source: Bloomberg Finance LP, Factset, Deutsche Bank

Take a look at the chart above. Notice how buybacks exploded at the beginning of 2013. This is exactly when the stairway to heaven rally in the market began. What happened was that interest rates were zero and the Fed announced a giant quantitative easing bond buying program. When the Fed stepped into the Treasury bond market they drove many private bond investors out of it. They artificially drove bond prices up and the interest rates bonds pay people down. So they made many people decide to simply not buy them who would have before. Would you want to tie your money up for 10 years for roughly 2% interest? Many asked that question and said no. And so some of them bought corporate debt and stocks.

You see money that wants to lend and buy bonds went into corporate America. They went into such things as the fracking boom that is now a bust. And they also went into corporate bonds that pay more interest than Treasury bills. And many of the companies used this borrowed money to launch stock buyback programs, because they didn't have any real investments to make that could actually growth their businesses.

THIS is how the Federal Reserve helped make the stock market go up and it is going to come to an end. THIS is why the stock market boomed while the real economy has languished.



Take a look at the chart above. You see as a whole corporate America is actually borrowing money to do buybacks. It is making less revenue than it is spending to pay dividends and do stock buybacks. Low rates and quantitative easing made this possible.

This will hurt these companies from a competitive standpoint. Over 1,000 companies are spending more on buybacks as a percentage of their net income as they are on innovation and research and development. R&D took up about 60% of corporate America's net income in the 1990's and now it takes up 50%.

Buybacks cause earnings per share to grow, because they reduce the number of shares outstanding. This is why corporate earnings grew during the past few years despite the fact that companies actually hired very few new people and spent little on capital investment. And corporate debt has exploded to pay for buybacks. Of course some CEO's, such as the current CEO of Apple, has used buybacks to dump millions of shares into the market and make a fortune. And he is just one of hundreds. Bubble bulls though do not care about any of this as they want to believe that the stock market will just go up forever and that buybacks will help make that possible.

The problem with these buybacks is that they are not going to be able to continue like this forever and we have likely already seen their peak. In order to make sure you understand what I mean look at this chart.

This is a chart of the interest rates for junk bond debt. Notice how it reached a record low in 2013, which coincided with the Fed's QE program and the start of the stairway to heaven rally generated by stock buybacks and the explosion in corporate debt. When junk bonds go up in value the interest rates for them drop and when bonds fall in value their interest rates go up.

These corporate buybacks are what enabled the stock market to go up. It wasn't direct Fed manipulation as some like to believe. Yes, the Fed policies helped make it happen. By keeping rates low and buying Treasury bonds the Fed created distortions in the allocation of investment capital that went into the corporate bond market. When the Fed makes interest rates artificially low it helps create a bubble somewhere. In 1999 it was in internet and tech stocks. After that it was in real estate and mortgage securities that helped create the crash of 2008. And now it is in this corporate junk bond market that is becoming unwound in front of our eyes that is causing another stock market disaster. The Fed created ANOTHER bubble disaster!

Corporate America has turned itself into Tyco back in 2003. Our corporate leaders have borrowed money in aggregate not to hire more people or increase their productive operations through organic growth, but to use the money to increase headline earnings per share via financial engineering whether that be through corporate buybacks or through mergers and acquisitions. This is why stock prices went up during the stairway to heaven rally while the economy stagnated and S&P 500 profit growth has been in the red for the past year-over-over. You can see on the how the record low in junk bond yields in 2012 helped start it all. You can thank Bernanke and Yellen! And Goldman Sachs and other Wall Street pumpers say the junk debt is just going to grow and grow and grow in 2016 too, but will it?

It won't because junk bonds are already beginning to fall in price, which means the rate of interest for them is slowly going up. This is going to eventually cause the stock buybacks to come to an end!

This is the most interesting chart right now. It's the JNK ETF which owns junk bonds and it's in a terrible downtrend. It shows you that the corporate debt bubble is beginning to unwind.

JNK spent the past year and a half forming a giant top with support at the $35 level and went below that level in January. The big drop in the stock market then followed.

JNK is clearly in a bear market now. What this means is that the interest rates for corporate bond debt is going to up over time. And the higher it goes the quicker we will see buybacks go away. And without the fuel of corporate stock buybacks the stock market will be doomed.

Now JNK is bouncing. That bounce is what has really helped make the stock market go up on this rally. But JNK is now extremely overbought. RSI on it is over 70 and its daily stochastics are above 80. Both of these are technical charting momentum indicators and you have to go back to almost a year ago to see JNK as overbought as it is now. The daily 20-day Bollinger Bands on JNK are also now extremely wide apart from one another which suggests that the recent move is unsustainable and has run its course.

Once JNK starts to drop again so will the stock market. I think that should begin to happen before this month is over. JNK is likely to top and go sideways for a few days or a week or two and then begin to decline again.

The Federal Reserve said at the end of last year that the US economy was on a path to "normal" so that it was going to be able to raise interest rates four times in 2016. But the Fed fund futures traders are now putting the odds of four rates hikes this year at zero, because of the stock market turmoil. And they are giving the odds of just one rate hike in December at less than 50%!

What this means is that we have not returned to a "normal" condition for the US economy. The Fed raised rates once last year and after a little stock market weakness it cannot really do it even one more time. That is a sign of how out of whack their policies have made the economy.

All the Federal Reserve has done is create another giant bubble with its zero interest rate policies and quantitative easing programs of the past eight years in the corporate debt market and the stock market. This is a bubble that is now unwinding and they cannot stop that process.

This is why the stock market is slowly dying and so many insiders are cashing out. Those who remain fully invested in the stock market will be left holding the bag.

Ultimately there are two ways to profit from this situation. One is to own gold and mining stocks that will go up as gold prices continue higher. Gold is now in a bull market and acting as a safe haven for investors. In bull markets you buy on dips and pauses. You cannot predict when they will happen all you can do is watch and wait and take advantage of them when they do. In bear markets though you cannot predict exact tops of rallies either, but you must use rallies to get out of positions you no longer want to own. This month is the time to do that when it comes to the US stock market.

The second way is to bet against junk stocks. In bear markets the troubled stocks fall the most. I have been doing that this year and released an entire program for you to do it with me. If you are not a Power Investor member you need to grab this program and begin now. As a bonus you will even get a Power Investor membership with it so that you can be on top of these markets and all of the things that are just starting to happen.

To do that go here:

http://wallstreetwindow.com/beta/posstocksprogram.htm

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